



STATE OF MICHIGAN

JENNIFER M. GRANHOLM
GOVERNOR

OFFICE OF THE STATE BUDGET
LANSING

MARY A. LANNOYE
DIRECTOR

December 27, 2004

The Honorable Jennifer M. Granholm, Governor
Members of the Legislature
People of the State of Michigan

As required by Article 9, Section 21, of the State Constitution and Section 494, Public Act 431 of 1984, as amended, we are pleased to submit the *State of Michigan Comprehensive Annual Financial Report* (SOMCAFR) for the fiscal year ended September 30, 2004.

INTRODUCTION TO THE REPORT

Responsibility: The Office of the State Budget, Office of Financial Management, prepares the SOMCAFR and is responsible for both the accuracy of the data and the completeness and fairness of the presentation, including disclosures. To the best of our knowledge and belief, the information contained in the SOMCAFR is accurate in all material respects and reported in a manner that fairly presents the financial position and results of operations of the State primary government and component units for which it is financially accountable. All disclosures necessary to enable the reader to gain a reasonable understanding of the State's financial affairs have been included.

Adherence to Generally Accepted Accounting Principles: As required by State statute, we have prepared the financial statements contained in the SOMCAFR in accordance with generally accepted accounting principles (GAAP) applicable to state and local governments, as promulgated by the Governmental Accounting Standards Board (GASB). The State also voluntarily follows the recommendations of the Government Finance Officers Association of the United States and Canada (GFOA) for the contents of government financial reports, and participates in the GFOA's review program for the Certificate of Achievement for Excellence in Financial Reporting.

Report: The SOMCAFR is divided into three major sections: introductory, financial, and statistical:

- The introductory section includes this letter, the State's organization chart, and the list of principal officials.
- The financial section includes: the independent auditor's report on the Basic Financial Statements; Management's Discussion and Analysis (MD&A) which provide an introduction, overview, and analysis to the Basic Financial Statements; the Basic Financial Statements, which present the government-wide financial statements and fund

financial statements for governmental funds, proprietary funds, fiduciary funds, and component units, together with footnotes to the Basic Financial Statements; Required Supplementary Information other than MD&A, which presents budgetary comparison schedules and information about infrastructure assets; and the supplemental financial data which includes the combining financial statements and schedules.

- The statistical section includes such items as trend information, information on debt levels, and other selected economic and statistical data.

Internal Control Structure: The Office of the State Budget is responsible for the overall operation of the State's central accounting system and for establishing and maintaining the State's internal control structure. The system of internal control has been designed to provide reasonable rather than absolute assurance that the financial statements are free from material misstatement.

All financial transactions of the State primary government are recorded in the central accounting system, except for the Michigan Unemployment Compensation Funds, Attorney Discipline System, the State Employees' Deferred Compensation Funds, the State Employees' Defined Contribution Retirement Fund, and the Michigan Education Savings Program. Many of the essential control features are decentralized, such as the preparation and entry of expenditure transactions into the central accounting system. Consequently, the Office of the State Budget relies upon the controls in place at the various State departments and agencies.

The Management and Budget Act requires each principal department to appoint an internal auditor and to maintain adequate internal control systems. Each department is also required to periodically report to the Governor on the adequacy of its internal accounting and administrative control systems and, if any material weaknesses exist, to provide corrective action plans and time schedules for addressing such weaknesses. This reporting is required on or before May 1 of each odd numbered year, effective as of the preceding October 1.

The discretely presented component units generally operate outside the State's central accounting system and are responsible for establishing and maintaining their own separate internal control structures.

Independent Auditors: The Office of the Auditor General (OAG) is the principal auditor of the SOMCAFR. The OAG also relies on the opinions of outside public accounting firms, particularly for component unit financial statements (such as the Michigan State Housing Development Authority and 10 of the State's universities), the larger pension and other employee benefit trust funds, and the Unemployment Compensation funds. The purpose of the OAG's audit is to provide reasonable assurance that the Basic Financial Statements for the fiscal year ended September 30, 2004 are free of material misstatements. The OAG concluded that the Basic Financial Statements for the fiscal year ended September 30, 2004 are fairly presented in accordance with GAAP and issued unqualified opinions.

In addition to the annual audit of the SOMCAFR, the OAG also performs periodic financial statement and performance audits of the various State departments, agencies, and institutions of higher education. The Auditor General also has primary responsibility for conducting audits under the federal Single Audit Act of 1984. Pursuant to Michigan Public Act 251 of 1986, these audits are conducted biennially for applicable State departments, agencies and component unit authorities, and result in separately issued audit reports.

Management's Discussion and Analysis (MD&A): GAAP requires that management provide a narrative introduction, overview, and analysis to accompany the Basic Financial Statements in the form of MD&A. This letter of transmittal is intended to complement MD&A and should be read in conjunction with it. The MD&A can be found immediately following the Independent Auditor's Report.

PROFILE OF THE GOVERNMENT

Michigan was admitted to the Union as the 26th state in 1837. The State is governed under the Constitution of 1963, as amended.

Executive Branch: The Executive Branch consists of 19 principal departments. Sixteen principal departments are headed by commissions and/or directors appointed by the elected governor. Two principal departments, Attorney General and State, are headed by elected officials and one, Education, is headed by an elected board.

Judicial Branch: The Judicial Branch consists of the Supreme Court, Court of Appeals, Court of Claims, and the State's circuit, district, probate, and municipal courts. In addition to its judicial duties, the Supreme Court is responsible for the general administrative supervision of all courts in the state. The Supreme Court also establishes rules for practice and procedure in all courts.

Legislative Branch: The Legislative Branch consists of the Senate, House of Representatives, and Office of the Auditor General. The Senate, which consists of 38 elected members, and House of Representatives, which consists of 110 elected members, enact the laws of Michigan. The Office of the Auditor General conducts post financial and performance audits of state government operations

Reporting Entity: The financial reporting entity of the State includes all of the funds of the primary government as

well as component units for which the State's elected officials are financially accountable. The transmittal letter, MD&A, and the financial statements focus on the primary government and its activities. Although information pertaining to the component units is provided, their separately issued financial statements should be read to obtain a complete overview of their financial position.

Budgetary Reporting and Control: For the State primary government operating funds (i.e., the General Fund and annually appropriated special revenue and permanent funds), the State budgets projected revenues and expenditures and calculates fund balance for budgetary purposes in accordance with GAAP. Public Act 431 of 1984, as amended, prohibits the State from budgeting for an ending fund balance deficit in an operating fund. If an actual deficit is incurred, the Constitution and Act 431 require that it be addressed in the subsequent year's budget. If accounting principles change, Act 431 requires the State to also implement such changes in its budgetary process.

Compliance with the final updated budget for the annually budgeted operating funds of the State primary government is demonstrated in the budget and actual comparative schedules and notes in the SOMCAFR. In addition, subsequent to the publication of the SOMCAFR, the State releases "Statewide Authorization Dispositions", a report providing line item appropriation details, the legal level of budgetary control, for the General Fund and budgeted operating funds.

ECONOMIC CONDITIONS AND OUTLOOK

The current U.S. economic recovery is now three years old, having begun in November 2001. Over the past six quarters, real annualized GDP growth has exceeded 3.0 percent each quarter. In five of the past six quarters, consumption growth has been strong and equipment investment has grown at double-digit rates. Light vehicle sales have remained strong throughout the recovery, boosted by record incentives and low financing rates. Supported by historically low interest rates, new and existing home sales have remained strong as well.

However, employment growth lagged the recovery. Employment declined each quarter during the recovery until the fourth quarter of 2003. Employment has grown in each of the past four quarters, but that growth has been uneven. Employment reported tepid growth the last quarter of 2003 and moderate growth in the first quarter of 2004; employment then surged in the second quarter of this year before moderating in the third quarter. Employment recorded a strong increase in October, but employment growth was tepid in November. Continued job growth will be key to sustained economic growth.

Despite recent growth, U.S. payroll employment in November was still about 400,000 jobs below its March 2001 peak. Further, some sectors are still struggling. The manufacturing sector has been particularly hard hit. U.S. manufacturing employment declined for 42 straight months, before reporting solid gains in early 2004. However, in recent months, manufacturing employment has declined slightly. Rapid productivity gains have allowed firms to

reduce payroll employment even as they have continued to increase output.

2004 Michigan Economic Review: Michigan's economy relies heavily on the performance of the manufacturing sector in general and the auto industry specifically. Given extremely weak Big 3 market share along with continued supply rationalization among vehicle suppliers, Michigan's employment performance has been below the national average. Substantial productivity gains in the manufacturing sector and vehicle industry have also contributed to Michigan's sub-par employment performance.

Over the past three years, the annual average for wage and salary employment has fallen. Through October, state employment is down compared to a year ago. From Michigan's employment peak in June 2000 compared to October 2004, Michigan has lost more than 300,000 jobs. By this time after the 1990-1991 recession, Michigan employment had risen nearly 200,000 jobs above its pre-recession peak. Michigan manufacturing employment has declined even more sharply. Since June 2000, Michigan manufacturing employment has fallen by slightly more than 200,000 jobs. However, while both overall and manufacturing employment have trended down since June 2000, the rate of that decline has slowed. Through October, state employment has increased in two of the last three months.

Michigan's annual average unemployment rate for 2003 was 7.3 percent, the highest level since 1992. The most recent monthly unemployment reading in October 2004 was 6.6 percent. The state's unemployment rate is down 1.0 percentage point from a year ago but substantially above its lows, around 3.0 percent, during the expansion of the late 1990s. Wages and salaries grew 0.6 percent year-over-year in the second quarter of 2004. Overall personal income grew 3.1 percent year-over-year in the second quarter.

The Department of Treasury and House and Senate Fiscal Agencies met on December 3, 2004, and reached a consensus for the 2004 and 2005 revenue and economic forecasts. The following summarizes the consensus economic forecast for 2005.

2005 U.S. Consensus Economic Outlook: Conference parties reached agreement on the outlook for several key economic variables. According to the Consensus forecast, real GDP is forecast to grow 3.2 percent in 2005, after growing a projected 4.4 percent in 2004. U.S. light vehicle sales are forecast to continue to be relatively steady with sales expected to be 16.7 million units in 2004 and 16.8 million units in 2005. The import share of those sales is expected to continue to rise, increasing from 19.9 percent in 2003 to 20.1 percent in 2004 and 20.6 percent in 2005. The U.S. unemployment rate is expected to decline from 6.0 percent in 2003 to 5.5 percent in 2004 and 5.4 percent in 2005. Interest rates are projected to rise over the forecast horizon but still remain at historically low levels as the Federal Reserve continues to raise the target federal funds rate at a measured pace. The Treasury bill rate is forecast to rise from 1.4 percent in 2004 to 2.4 percent in 2005. As measured by the consumer price index (CPI), inflation is expected to remain moderate with consumer prices rising a projected 2.6 percent, down slightly from 2.7 percent in 2004.

As businesses gain confidence in the sustainability of the expansion, business investment is expected to remain strong and the labor market is projected to firm up. With a firmer labor market and continued low interest rates, consumption is projected to remain solid. At the same time, higher oil prices, rising interest rates, and an end to the tax cuts will act to slow growth in 2005.

2005 Michigan Consensus Economic Outlook: With continued U.S. economic growth, smaller declines in manufacturing sector employment and improvements in the private non-manufacturing sector, Michigan employment is expected to grow each quarter, with employment gains averaging a modest 8,000 jobs per quarter.

For 2004, employment is estimated to have declined by 49,000 jobs (1.1 percent) – the fourth straight annual Michigan employment decline. With slight growth in 2005, employment is forecast to average 0.3 percent higher than 2004 employment. After falling from 7.3 percent to 6.7 percent in 2004, Michigan's unemployment rate is forecast to rise to 6.9 percent in 2005.

Michigan personal income is projected to rise 4.5 percent in 2005, after increasing an estimated 2.7 percent in 2004. In 2005, wages and salaries income is forecast to grow 3.7 percent after rising slightly (0.7 percent) in 2004. As measured by the Detroit CPI, consumer prices are projected to increase 2.4 percent.

The Department of Treasury and House and Senate Fiscal Agencies will meet again on January 13, 2005, for a Consensus Revenue Estimating Conference. At that conference, the agencies will reach consensus economic and revenue forecasts for 2005 and 2006.

MAJOR INITIATIVES AND FUTURE PROJECTS

Education: Despite tough economic times, the State remains committed to quality education at all age levels. Over \$14.5 billion, or 37 percent, of the State's total FY 2004-2005 budget is devoted to education. This includes funding for early childhood programs, the K-12 system, universities, community colleges, and student financial aid.

As part of its overall goal of improving student achievement, the State continues to place emphasis on learning in the critical preschool years by investing in programs that provide quality early childhood learning, childcare, and parental education. The State has also instituted a program to identify and assist schools that are considered high priority for improvement in academic achievement.

Health and Human Services: Protecting Michigan's most vulnerable citizens is also a high priority. For FY 2004-2005, the two departments primarily responsible for health and human services, the Department of Community Health and Family Independence Agency, account for \$14.1 billion, or 36 percent, of the overall State budget.

While the State administers a variety of health and human services programs, Medicaid is the most extensive, accounting for \$8.6 billion of the FY 2004-2005 budget. These funds allow the State to provide health care services for over 1.3 million low-income citizens.

Economy: State government is committed to growing its economy by sustaining and creating business investment and jobs in Michigan. One of the key initiatives in this area is the Technology Tri-Corridor, which fosters growth in life sciences, advanced automotive technologies, and homeland security industries through funding and resource collaboration, focusing on emerging technology sectors. Financing is available through a competitive proposal process for life sciences, advanced automotive technologies and homeland security companies and researchers.

Other initiatives related to the economy include the Michigan Timely Application and Permit Service (MiTAPS), which provides one-stop shopping for businesses to identify and apply for permits needed to do business in Michigan; the Michigan Broadband Development Authority, which promotes broadband deployment and utilization in Michigan to stimulate economic development and organizational efficiency; and the Cool Cities Pilot Project, aimed at keeping and attracting young, educated, and skilled workers.

Hometown Security: Michigan is now benefiting from the services of 89 additional Michigan State Police Troopers as a result of the recent completion of the 120th Trooper Recruit School. This is the first trooper recruit school held since 2001. With the addition of these troopers, 1,095 troopers are assigned to posts located throughout the state.

Michigan is also in the midst of a variety of efforts to control the growth in the prison population without sacrificing the safety of its citizens. As a result of these efforts, the State has been able to forego the reopening of two closed prisons, saving \$60 million. It also expects to close an additional prison during FY 2004-2005 by shifting prisoners from an older, less cost-efficient facility to a newer, underutilized facility.

Better Government: State government continued to become more efficient during FY 2003-2004 by implementing administrative measures that reduced spending by \$185 million. Most of the savings resulted from ongoing improvements in contracting practices, such as reducing the number of sole source contracts, eliminating contract extensions, and negotiating price reductions. Other examples of savings included continued reductions in the number of cars in the State's fleet, debt restructuring, voluntary

rent reductions for leased facilities, and decreased energy consumption.

The State also streamlined routine human resources, benefits, and payroll functions by opening a centralized service center that provides services and support to State employees in most executive branch departments. Establishment of the centralized service center is expected to save the State \$25 million over the next five years by reducing the number of staff needed in departmental human resources offices.

In order to ensure that Michigan citizens get maximum value for their future tax dollars, the State has modified its budget development process to incorporate a "budgeting for outcomes" approach for the FY 2005-2006 budget year. Budgeting for outcomes differs from the traditional approach by focusing on buying results for citizens rather than cutting or adding to last year's budget. The goal is to get the results citizens need at the price they are willing to pay.

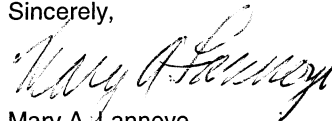
AWARDS AND ACKNOWLEDGEMENTS

Certificate of Achievement: The GFOA awarded a Certificate of Achievement for Excellence in Financial Reporting to the State of Michigan for its SOMCAFR for the year ended September 30, 2003. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized comprehensive annual financial report whose content satisfies both generally accepted accounting principles and applicable legal requirements.

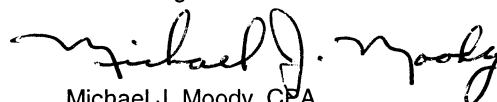
A Certificate of Achievement is valid for a period of one year only. The State has received a Certificate of Achievement for 17 consecutive years. We believe our current report continues to conform to the Certificate of Achievement program requirements, and we are submitting it to the GFOA to determine its eligibility for another certificate.

Acknowledgments: The preparation of this report requires the collective efforts of the management and staff of the Accounting and Financial Reporting Division, Office of Financial Management; the chief financial officers, chief accountants, internal auditors and their staffs from all State agencies; and the management and staff of the Office of the Auditor General. We sincerely appreciate the dedicated efforts of all of these individuals that have allowed Michigan to maintain its position as a national leader in quality and efficiency for financial reporting.

Sincerely,



Mary A. Lannoye
State Budget Director



Michael J. Moody, CPA
Director, Office of Financial Management